

**Questions and Answers**  
**on**  
**Key Considerations for Inventory**  
**Counts under COVID-19 Situation**

*Guidance for Auditors*

From the Desk of Technical Services

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- *In this publication the terms 'inventory count' and 'stock-take' are used interchangeably.*

## Questions and Answers

### Question 1:

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#### Whether the auditor is always required to attend the stock-take?

In accordance with ISA 501 (paragraph 4), if inventory is material to the financial statements, the auditor needs to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting (i.e. stock-takes), unless impracticable.

The auditor, therefore, with the exception of following two situations, is required to attend the physical stock-take of the entity. The two exceptions when auditor may not attend the physical stock-take are:

- When inventory is not material; or
- When it is impracticable to attend stock-take.

### Question 2:

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#### Whether the auditor is required to be physically present for attending the stock-take?

The observation of inventory count is to enable the auditor to check whether the stock-take procedures are properly followed, and to conduct test counts to check that the procedures and internal controls over stock-take are satisfactory.

In accordance with ISA 501 (paragraph 4), the auditor is required to 'attend' the stock-take. Auditor's attendance could be physical or virtual (through the use of technology).

### Question 3:

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#### When it could be impracticable for the auditor to physically attend stock-take?

ISA 501 requires auditor's attendance at the stock-take. However, ISA 501 (paragraph 7) also recognizes that in some cases attendance at stock-take may be impracticable for the auditor.

ISA 501 indicates that one circumstance that may make a physical observation impracticable is if the inventory is held in a location that may pose threats to the auditor's safety. In present environment, various factors need to be considered by auditor while deciding to physically attend the stock-take, including government instructions, safety of audit staff and entity's position in context of audit team's attendance. The COVID-19 health and safety concerns and government-imposed travel restrictions in certain cases may make it impracticable for the auditor to physically attend the stock-take of the entity.

Where the auditor is facing challenges in physically attending the stock-take at the financial year end of the entity, auditor may attend the stock-take remotely by using technology, such as video-conferencing. Further, the auditor may agree with the management to observe stock-take at an alternate date. Therefore, the use of technology or stock-take at a date other than the entity's year-end may alleviate the present situation of impracticability.

It is also important for the auditor to use professional skepticism and also consider the application guidance of ISA 501. ISA 501 does not explain "impracticable" in the context of being unable to attend an inventory count. It explains that the matter of general inconvenience to the auditor, is not sufficient to support a decision by the auditor that attendance is impracticable.

Further, as explained in ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, the matter of difficulty, time, or cost involved is not, in itself, a valid basis for the auditor to omit an audit procedure for which no alternative exists or to be satisfied with audit evidence that is less than persuasive.

In COVID-19 related circumstances, auditor would be required to use judgment in concluding that whether restrictive measures and safety concerns are making the stock-take impracticable. It is important to highlight, that auditor's judgment and decision would be based on various factors, including understanding of the entity's business, nature and location of the inventory, inventory count by other entities (specially of the same locality and business sector), reasons for inability to physically attend the stock-take.

If auditor determines that it is impossible to attend inventory counting physically and virtually, the auditor must assess whether alternative audit procedures can be performed.

#### **Question 4:**

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##### **Can the auditor attend stock-take virtually by using technology?**

Where the auditor is facing challenges in physically attending the stock-take, it may attend the stock-take remotely by leveraging the use of technology, such as video-conferencing.

However, in doing so, the auditor need to plan and execute the observation to achieve the results intended. The use of technology for attending stock-take must be applied with great care. The auditor should exercise professional judgement in deciding on the appropriateness of using technology such as drones or live video conferencing to assist in observing the process of physical inventory counting.

In this publication (Question 11, Question 12, Question 13 and Question 14) highlight some key considerations for the auditor for using technology for virtual attendance at the stock-take.

#### **Question 5:**

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##### **If management refuses to conduct stock-take on the financial year-end (e.g. June 30), in such a scenario how the auditor would obtain audit evidence on inventory?**

In certain cases, management may refuse to conduct the stock-take on the financial year-end (e.g. June 30 and onwards). In such cases auditors should engage with the management to understand the reasons for management's inability to conduct the stock-take at the financial year-end.

The auditor needs to use professional skepticism to evaluate management's rationale for not conducting the stock-take on June 30. For example, the auditor may be skeptical if entity has continued operations at its facilities and there are no government or other restrictions that would appear to prevent the counts from otherwise occurring. Similarly, the auditor may be skeptical if entities in same locality or line of business are carrying out the stock-take on the financial year end.

The auditor also needs to understand what the entity's plan is to determine stock quantities and subsequently its stock valuation for the year-end financial statements.

If auditor concludes that management's explanations for not conducting the stock-take on June 30 appear to be reasonable in the circumstances (for example, the locations where inventory is held are closed and warehouse employees are confined to their homes due to a government imposed lockdown), auditor should discuss with management to carry out a stock-take on another date before or after year-end when restrictions are lifted or concerns reduced. The auditor should perform procedures such as:

- Observe management's count on the date of stock-take, and perform independent counts of inventory on hand (floor-to-sheet and sheet-to-floor) and perform appropriate roll-forward/roll-back procedures.

- Evaluate the appropriateness of testing movements from the count date to the financial statements date by performing the role-forward or role-backward procedures.
- Perform cut-off tests using goods inwards/dispatch notes and quantities checked to after date of sales invoices.

If management refuses to conduct stock-take, auditor should consider the impacts on audit, including risk assessment and ability to obtain sufficient appropriate audit evidence. Where auditor concludes that a management-imposed scope limitation exists, the matter is communicated to those charged with governance, and if scope limitation is not relieved then it is reported in the audit opinion.

#### **Question 6:**

**If management refuses to conduct stock-take on the financial year end and also on any other alternate date, in such a scenario how the auditor would obtain audit evidence on inventory?**

As explained above, in cases where management advises that it not feasible to conduct stock-take on the financial year end, the auditor should understand management's rationale and engage with management to perform inventory count on an alternate date. The auditor should also update management regarding the information required for performing alternative procedures. Further, the auditor should inform management of possible implications on the audit opinion.

Accordingly, the auditor should first discuss with management whether it is possible to perform count at a later date when it is practicable for the management. Where the count is performed at a later date, the auditor shall perform the necessary roll-back procedures.

In certain cases, delaying the count or carrying out count on an alternate date may not be feasible. For example, where there are government-imposed restrictions, or if the nature of the entity's business is such that inventories are voluminous and fast-moving resulting in difficulties in performing roll-back procedures. In such cases, the auditor need to consider the alternative procedures. However, the auditor should carefully assess whether the conditions really result in an impracticable situation with reference to paragraph A12 of ISA 501 and document the assessment accordingly.

If management refuses or expresses inability to carry out inventory count on another alternate date, the auditor should perform alternative procedures to obtain evidence over the existence and condition of inventories. These procedures, among others would include:

- Inspecting the documentation of subsequent sale of specific inventory items acquired or purchased prior to the year-end physical inventory counting.
- Performing substantive analytical procedures, such as analyzing cost of sales to inventory ratio. The auditor should be mindful when performing such procedures as predictive relationships based on historical trends may no longer be appropriate arising from the implications of COVID-19.
- Assessing the effectiveness of controls over inventory counts performed during the period under audit. The auditor may conclude that such controls are operating effectively through audit procedures performed during current period stock-take.
- During such assessment, the auditor should also consider past experience with the entity's inventory management, such as if there is a history of differences between management's count results and inventory records.

Auditor's arrangement to visit the warehouse to conduct tests when the relevant premises are closed and no staff are present will not provide audit evidence relating to inventory counting procedures, and the substantive evidence based on sampling procedures relating to the existence and condition of inventory would be very limited. Auditor may need to limit the scope of audit opinion in such cases.

**Question 7:**

**What would be the audit implications, where entity has performed a stock-take at financial year-end, however auditor could not attend the stock-take?**

In certain cases, management may have performed the inventory count, however, due to safety concerns or travel restrictions the auditor may not be able to attend the stock-take in person.

As explained earlier, in such cases the auditor may consider the use of technology for attending the stock-take virtually. However, this would be subject to various factors as outlined in response to the use of technology.

The auditor after consideration of various factors, such as safety concerns, travel restrictions and non-feasibility of virtual attendance, should communicate its inability to attend the stock-take carried out by management.

In consideration of above factors, the auditor should also request management for a stock-take on an alternate date. On such alternate date, the auditor shall make or observe some physical counts and perform audit procedures on intervening transactions.

However, in certain cases, management may carry out a stock-take without auditor's attendance and also refuse to the auditor's request of another stock-take on an alternate date. In such cases, the auditor's attendance at the stock-take may be deemed impracticable as auditor owing to circumstances might not be able to attend the stock-take due to the safety concerns or travel restrictions.

The implications of not attending the inventory count being carried out by entity could have implications on the audit approach, procedures and opinion. Therefore, the auditor should evaluate the circumstances carefully and use professional skepticism and judgment:

- While deciding to not attend entity's stock-take;
- When concluding that it is impracticable to attend entity's stock-take, as entity has refused for an alternate stock-count; and
- When deciding if alternative procedures sufficiently make up for the lack of attendance at the physical inventory count conducted by the entity.

It is also auditor's responsibility to assess the sufficiency and appropriateness of these alternative procedures. In consideration of above, the auditor should critically evaluate the decision of not attending the entity's stock-take as the lack of sufficient appropriate audit evidence through alternative procedures could impact the audit opinion.

**Question 8:**

**How should an auditor obtain audit evidence on inventory when it is impracticable for the auditor to attend the stock-take?**

A possible scenario could be that management conducts a physical inventory count that auditor has determined impracticable to attend. In this scenario auditor should:

- Document considerations and the basis for its conclusions in work papers; and
- Perform alternative audit procedures to obtain sufficient appropriate audit evidence as to the existence and condition of inventory.

For the auditor's performance of alternative procedures, management would need to demonstrate controls over inventory movements. The auditor should be able to test and place reliance on those controls.

If the auditor has attended last stock-take, then management would need to provide information for the auditor to perform roll-forward audit procedures.

The Roll-forward procedures, among others would include:

- Testing of relevant controls;
- Vouching purchases of inventory during the intervening period;
- Vouching sales of inventory using the intervening period;
- Testing inventory sales and purchases for proper cut-off at period end;
- Testing the accuracy of inventory reconciliation to the general ledger at the period end, including tests of reconciling items; and
- Performing substantive analytical procedures to evaluate sales, cost of sales, gross margin, inventory turnover.

The incoming auditor of an entity (previous year stock-take attended by predecessor auditor) may also perform alternative procedures including roll-forward procedures, where the incoming auditor is unable to attend the current year stock-take.

#### **Question 9:**

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##### **What are the relevant considerations when planning alternative audit procedures?**

When designing alternative audit procedures, auditor has to consider multiple factors, such as:

- the assessed risk of material misstatement associated with physical existence and condition of inventory;
- The carrying amount of inventories relative to performance materiality;
- The nature of inventories (e.g. raw materials, WIP, Finished Goods) as well as whether they are separately identifiable, require judgment to determine quantities, the types and number of items in the population, the frequency and volume of movements;
- The results of management's inventory count, if one was conducted;
- Whether production and/or sales have been halted;
- Controls over inventory movements and whether we are able to test and place reliance on them;
- When auditor last attended an inventory count, and whether roll-forward procedures could provide sufficient appropriate audit evidence
- If inventory is held at multiple sites, whether auditor was able to attend inventory counts at some locations and can perform alternative procedures to address the remaining population; and
- Whether inventory at period end has since been sold.

**Question 10:****What are key considerations in the roll-backward and roll-forward audit procedures?**

The auditor should determine the roll-backward and roll-forward procedures (as the case may be) and consider whether these procedures could provide sufficient appropriate audit evidence.

In case the physical stock-take would be conducted at a date other than the date of financial statement, then the information between the intervening period (i.e. stock-take date and date of financial statements) would be crucial.

With respect to roll-backward or roll-forward procedures, it is also highly desirable to keep the intervening period to as short a period as possible. Generally, as the length of these procedures increases, the persuasiveness of audit evidence provided by the last stock-take combined with the roll-forward procedures provide for the existence of inventory quantities at the reporting date decreases.

Further, with the performance of roll-back or roll-forward procedures, evidence will be needed relating to the condition of the inventory at the year end.

**Question 11:****What are the key considerations for the auditor when deciding to use technology for attending the stock-take?**

Auditors need to consider various factors before deciding to use video technology for attending the entity's stock-take. Some of the significant and relevant factors include:

- Inventory system: Does the client maintain a perpetual inventory system?
- Quality of technology: Is the quality of the technology tool being used during the observation of physical inventory counting at an acceptable level?
- Auditor's virtual access and completeness of inventory: Does the technology tool allow the auditor to look around the client's premise without any limitation? Are there any restricted areas within the client's premises, especially the warehouse?
- Evaluation of condition of inventory: Does it allow the auditor to evaluate the condition of the inventory, including identifying any obsolete, damaged or aging items?
- Auditor's observation: Does it allow the auditor to observe clearly the procedures of physical inventory counting? Would there be any limitations, such as observing the product code/label or verifying the weight of inventories?
- Experience of staff: Does the audit and client staff handling and controlling the technology tool have adequate experience? Is the client staff able to perform all the procedures like weighing the open inventory or estimating heaps of crush / sand with same accuracy and record observations as the auditor's team would or not?
- Communication with client: Are there tools that allow the auditor to communicate with the client's staff in order to select samples from the inventory list to physical inventory on the floor or from floor to list during physical inventory counting?
- Sample size and element of unpredictability: Will the stock-take include element of unpredictability. Increasing sample size and selecting on the call items to be counted, from both floor to sheet, and sheet to floor, will help to reduce this risk?

The above list of key considerations is not exhaustive. Therefore, the auditor is expected to continuously exercise professional judgement in determining whether any additional considerations are needed to address particular circumstances.



**Question 12:**

**What are the key considerations for the auditor when using technology for attending the stock-take?**

When using technology for attending entity's stock-take, the auditor should obtain sufficient and appropriate audit evidence by:

- Performing walk through of the warehouse via the selected device/technology to note the warehouse is set up as expected.
- Obtaining an understanding of the layout of the entire warehouse for purposes of making floor-to-sheet selections.
- Ensuring that appropriate segregation of duties is maintained during the count process.
- Ensuring that unique identifiers (e.g. identification numbers, tag number) are clearly made visible for each item selected.
- Ensuring that the shipping/receiving dock is not being utilized and no active production is noted.
- All other procedures traditionally conducted during a physical observation, particularly those that may be more difficult to perform remotely, including:
  - Verifying consignment inventory held has been excluded from the population subject to count.
  - Understanding management's means of assessing the accuracy of inventory stored in unique locations (e.g., silos, tanks, bins).
  - Assessment of electronic scanning/counting devices via a test of one.

The above list of key considerations is not exhaustive. It is expected of the auditor to continuously exercise professional judgement in determining whether any additional considerations are needed to address particular circumstances.

**Question 13:**

**What are the possible situations where use of technology for attending stock-take may not be suitable?**

In following circumstances and situations the use of technology may not be appropriate:

- The auditor in prior periods has identified material misstatements identified related to inventory existence, completeness, or rights & obligations.
- The auditor in prior periods has identified deficiencies related to inventory existence, completeness, or rights & obligations (e.g., deficiencies in the count control(s) or inventory receipt, relief, or management controls).
- Observation of work-in-progress inventory.
- Where production and shipping/receiving will not be shut down during the observation.
- Inventory observations require the assistance of a third-party expert and the expert cannot attend the count
- Management maintains a periodic inventory system.
- First-year audits where the auditor has never physically attended observations at the entity before.

The above list is not exhaustive, and auditors are expected to consider other specific scenarios that may not render the use of technology.

**Question 14:****What are the documentation requirements when using technology?**

The auditor is required to document the thought process on the use of technology for attending the stock-take. The auditor would be documenting the basis on which it concluded the unreasonableness of observing the count in person, given the COVID-19 situation.

The form, content, and extent of audit documentation depend on the circumstances of the engagement and the audit methodology and tools used.

Where the auditor uses technology in gathering audit evidence regarding the existence and condition of inventory, the auditor in general would be retaining the related electronic evidence. However, when transferring the information to another media (e.g. paper), the auditor should apply procedures to ensure that the information and audit evidence obtained through technology is same as that of the source material. The auditor is also required to include his conclusions reached thereon and the significant professional judgements made in reaching those conclusions.

The auditor is also reminded that whether audit documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the auditor's knowledge, or could be permanently lost or damaged. Accordingly, the auditor should apply appropriate and reasonable controls for audit documentation to:

- Clearly determine when and by whom audit documentation was created, changed, or reviewed;
- Protect the integrity of the information at all stages of the audit, especially when the information is shared within the audit team or transmitted to other parties via electronic means;
- Prevent unauthorized changes to the documentation; and
- Allow access to the documentation by the audit team and other authorized parties as necessary to properly discharge their responsibilities.

**Question 15:****Can the external auditor request entity's internal auditor to attend inventory count on his behalf?**

In accordance with ISA 610 *Using the Work of Internal Auditors*, the external auditor can obtain direct assistance of the internal auditor.

In context of COVID-19 situation, where external auditor's attendance at physical inventory counting is impracticable (for instance, inventory is held in a location that may pose threats to the safety of the auditor), the external auditor can consider to seek direct assistance of internal auditor by requesting to attend inventory count on his behalf.

However, external auditor is required to use professional judgment when deciding to obtain direct assistance of the internal auditor. The external auditor should consider following factors:

- Understand the internal auditor's organization status and threats to the independence of the internal auditor;
- Assess the competence level of the internal audit function;
- Amount of judgment involved in the obtaining audit evidence about inventory count; and

- Assessed risk of material misstatement in inventory.

In current environment, safety should be considered when requiring direct assistance of internal auditor for attending the inventory count. It would also not be advisable to request the internal auditor to attend the inventory count, if management are not already planning on sending internal audit staff to attend.

#### **Question 16:**

##### **What are the key considerations when entity's inventories are held by third-parties?**

The auditor should be alert to the situations as operations at the third-party that are holding entity's inventory might be disrupted by the lock-down measures and health and safety concerns. The auditor should accordingly obtain this information and consider the risk assessment and planned audit approach.

In accordance with ISA 501 (paragraph 8 and related application guidance paragraphs), if the entity's inventories are held at a third-party warehouse, the auditor may be able to rely on the third-party confirmation of the quantity and condition of inventory. The auditor (with or without obtaining third-party confirmation) may also apply one or more of the following procedures as considered necessary in the circumstances:

- Test the entity's procedures for evaluating third party's performance.
- Inquire directly from the third-party warehouse about their control processes, including potential impacts from COVID-19, and obtain supporting information.
- Obtain an independent auditor's report on the third party's control procedures relevant to custody of goods.
- Apply alternative procedures at the warehouse to gain reasonable assurance that information received from the third-party is reliable.
- Observe physical counts of goods, if practical and reasonable.

When relying on third-party confirmations, the auditor should assess the reliability of the confirmation and apply the requirements and guidance under ISA 505 *External Confirmations*. When considering the appropriateness of relying on confirmation of the third-party warehouse, the auditor should consider:

- Client controls to reconcile between the accounting records for inventory and the information provided by the third-party warehouse on a routine basis.
- The results of previously confirmed inventory at the third-party warehouse and whether there were reconciling items or errors noted on the confirmation.

This may also include understanding how the third-party was able to ensure the accuracy of their inventory records and the responsibilities of the third-party based on their agreement with the entity, such as if the third-party bears responsibility of stock loss or damage.

#### **Question 17:**

##### **What are the implications, when the auditor has been unable to obtain sufficient and appropriate audit evidence on inventory?**

If the auditor is unable to obtain sufficient appropriate audit evidence over the existence and condition of the inventories, in situations such as:

- Management is unable to perform its year-end physical inventory count;

- The auditor is unable to attend the entity's physical inventory count or carry out remote observations to achieve the auditor's objectives;
- The auditor is unable to perform roll-backward procedures from the inventory count date to the financial reporting date; or
- Alternative procedures do not provide sufficient appropriate audit evidence, this will likely present scope limitations that will impact the auditor's report.

It is important to highlight that an inability of the auditor to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. Therefore, if auditor has not been able to physically attend the stock-take, however, has been able to obtain sufficient appropriate audit evidence through alternate procedures, it would not be a scope limitation. The scope limitation would be when:

- Inventory is material to the financial statements; and
- Auditor is not able to obtain sufficient and appropriate audit evidence in relation to the existence and completeness of inventory, whether by procedures performed at the stock-take or by alternative procedures, there would be a limitation of scope.

This scope limitation may be imposed by circumstances or may be imposed by entity's management.

In such circumstances, the auditor should issue modified audit opinion, in accordance with ISA 705, *Modifications to the opinion in the auditor's report*. The modified opinion could be:

- Qualified opinion; or
- A Disclaimer of opinion

In most cases, the scope limitation would result in a qualified audit opinion. Reference should be made to illustration 3 in ISA 705. *(Please note that this illustration provides an example of a limitation of scope audit qualification, but this does not relate to an inventory related scenario. Therefore, this would need to be reworded appropriately but does illustrate how the concept should be applied.)*

In certain circumstances the auditors may need to issue a disclaimer of opinion if they conclude that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. Reference should be made to illustration 4 in ISA 705. *(Please note that this illustration provides an example of a limitation of scope audit disclaimer of opinion, but this does not relate to an inventory related scenario. Therefore, this would need to be reworded appropriately but does illustrate how the concept should be applied.)*

### **Question 18:**

**In current circumstances, what is the importance of auditor's communication with management and those charged with governance?**

Clear and timely communication of specific matters is integral part of every audit. As 30 June year end is approaching, companies should decide upon the course of action for the stock-take.

Given the possible practical issues and challenges in stock-take, it is important that management and auditor engage as early as possible to discuss audit considerations and take appropriate actions.

In the event the management is unable to schedule inventory count as at year-end date, the auditor should highlight to the management that roll-forward/ backward procedures on inventory quantities test counted during the physical inventory count to the financial year-end position need to be

performed by the management. The auditor should then audit this information provided by the management.

Auditors are also required to make certain communications to those charged with governance. The auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.

The communication may take place during different phases of the audit.

The auditor should communicate the planned scope and timing of the audit. Further, in context of stock-take auditor's communication would involve the expected dates of auditor's attendance to the stock-take and possible impact on the audit timelines. Further, auditor should inform significant audit findings, including any significant difficulties encountered in dealing with management related to the performance of the audit, including the stock-take.

## Requirements of ISA 501

As noted above, auditors are required to apply ISAs while conducting the audit of financial statements.

The requirements for auditor's attendance at stock-takes are set out in ISA 501 *Audit Evidence - Specific Considerations for Selected Items*.

Relevant paragraphs and the related application guidance of ISA 501 are reproduced below:

### Paragraph 4

If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1-A3)
  - i. Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; (Ref: Para. A4)
  - ii. Observe the performance of management's count procedures; (Ref: Para. A5) (iii) Inspect the inventory; and (Ref: Para. A6)
  - iii. Perform test counts; and (Ref: Para. A7-A8)
- b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

### *Attendance at Physical Inventory Counting* (Ref: Para. 4(a))

**A1.** Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

**A2.** Attendance at physical inventory counting involves:

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

**A3.** Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this ISA) include, for example:

- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations

attendance is appropriate. ISA 600<sup>1</sup> deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regard to attendance of physical inventory counting at a remote location.

- Whether the assistance of an auditor's expert is needed. ISA 620<sup>2</sup> deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

Evaluate Management's Instructions and Procedures (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

Observe the Performance of Management's Count Procedures (Ref: Para. 4(a)(ii))

A5. Observing the performance of management's count procedures, for example, those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or aging inventory.

Perform Test Counts (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example, by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

<sup>1</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>2</sup> ISA 620, *Using the Work of an Auditor's Expert*

**Paragraph 5**

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A11)

***Physical Inventory Counting Conducted Other than at the Date of the Financial Statements***  
(Ref: Para. 5)

- A9.** For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. ISA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date.<sup>3</sup>
- A10.** Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.
- A11.** Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:
- Whether the perpetual inventory records are properly adjusted.
  - Reliability of the entity's perpetual inventory records.
  - Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

**Paragraph 6**

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

**Paragraph 7**

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with ISA 705 (Revised). (Ref: Para. A12-A14)

***Attendance at Physical Inventory Counting Is Impracticable*** (Ref: Para. 7)

- A12.** In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in ISA 200,<sup>4</sup> the matter of difficulty,

<sup>3</sup> ISA 330, paragraphs 22-23

<sup>4</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A50



time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

- A13.** In some cases, where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.
- A14.** In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, ISA 705 (Revised) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.<sup>5</sup>

### Paragraph 8

If inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A15)
- (b) Perform inspection or other audit procedures appropriate in the circumstances. (Ref: Para. A16)

### *Inventory under the Custody and Control of a Third Party* Confirmation (Ref: Para. 8(a))

**A15.** ISA 505<sup>6</sup> establishes requirements and provides guidance for performing external confirmation procedures.

### Other Audit Procedures (Ref: Para. 8(b))

- A16.** Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:
- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
  - Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
  - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
  - Requesting confirmation from other parties when inventory has been pledged as collateral.

<sup>5</sup> ISA 705 (Revised), paragraph 13

<sup>6</sup> ISA 505, *External Confirmations*

**Disclaimer**

This publication considers the requirements of ISAs as applicable in Pakistan. In consideration of current circumstances, the publication outlines some of the key implications and responses for auditor's attendance at stock-takes, however appropriate responses to issues will depend on each audit's unique facts and circumstances. The matters, procedures and examples included in this document are not all-inclusive. Further analysis and judgment would be necessary in order for an auditor to apply the requirements to their own facts, circumstances and clients. For additional details on ISAs you would need to refer to the relevant literature. Further, the information provided in this document is for general guidance only and may change from time to time.